

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matter of

**Implementation of the
Telecommunications Act of 1996 :**

CC Docket No. 96-150

**Accounting Safeguards Under the
Telecommunications Act of 1996**

**COMMENTS OF AT&T CORP ON VERIZON'S SECTION 272
COMPLIANCE BIENNIAL AUDIT REPORT**

**David L. Lawson
R. Merinda Wilson
Michael J. Hunseder
Sidley Austin Brown & Wood, LLP
1501 K Street, NW
Washington, D.C. 20005
(202) 736-8000**

**Mark C. Rosenblum
Lawrence J. Lafaro
Aryeh S. Friedman
AT&T Corp.
295 North Maple Ave.
Basking Ridge, NJ 07920
(908) 221-2717**

Counsel for AT&T Corp.

April 8, 2002

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Pursuant to the Commission's Public Notice in the above entitled matter,¹ AT&T Corp ("AT&T") hereby submits its Comments on the Reports of Independent Accountants on Applying Agreed-Upon Procedures, prepared by PricewaterhouseCoopers LLP (the "Auditor") and filed on June 11, 2001 ("Auditor's Initial Biennial Report") and June 18, 2001 ("Auditor's Supplemental Biennial Report") (collectively the "audits") in connection with the first biennial Section 272 audit of the Verizon companies

I. INTRODUCTION AND SUMMARY

Section 272 of the Communications Act, 47 U.S.C. § 272, was enacted to bridge the chasm between the "fundamental postulate underlying modern telecommunications law" – that the Bell Operating Companies ("BOCs") will "have both the incentive and ability to discriminate against competitors in incumbent LECs' retail markets" until their monopoly local telephone

¹ See Public Notice, *In the Matter of Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket 96-150, (June 21, 2001), Order, CC Docket 96-150 (Feb. 15, 2002)

markets become fully competitive, *SBC/Ameritech Merger Order* ¶¶ 12, 190 (“This incentive exists in all retail markets in which they participate”) – and the Section 271 command that BOCs be allowed to provide long distance services when their local markets are merely *open* to competition.² Among other obligations, Section 272 requires a BOC, after obtaining Section 271 authority, to provide long distance and other services through independent and separate affiliates and to afford competing carriers the same treatment it provides to these affiliates. See 47 U.S.C. § 272, *Non-Accounting Safeguards Order*, *Accounting Safeguards Order*.³ In particular, these separate affiliate and related requirements are “designed, in the absence of full competition in the local exchange marketplace, to prohibit anticompetitive discrimination and cost-shifting.” *Non-Accounting Safeguards Order* ¶ 9.

But a nonstructural anti-discrimination rule can do little to combat bottleneck monopoly abuse unless it can be, and is, effectively enforced, and Congress was well aware of the long history of BOC evasion of such rules. That is why Congress expressly provided both for periodic, in-depth, independent audits of each BOC’s post-entry conduct and for penalties in the event of misconduct, including revocation of the BOC’s Section 271 authority. See 47 U.S.C. §§ 272(d), 271(d)(6). The Section 272 audit is thus of paramount importance. As the Commission concluded earlier this year, “the broad section 272(d) audit requirement and the mandatory public comment process are critical components in ensuring compliance with the

² Memorandum Opinion And Order, *Applications Of Ameritech Corp., Transferor, And SBC Communications Inc., Transferee, For Consent To Transfer Control Of Corporations*, 14 FCC Rcd 14712 (1999).

³ First Report and Order and Further Notice of Proposed Rulemaking, *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended*, 11 FCC Rcd 21905 (1996) (“*Non-Accounting Safeguards Order*”), Report and Order, *Accounting Safeguards Under the Telecommunications Act of 1996*, 11 FCC Rcd 17359 (1996) (“*Accounting Safeguards Order*”).

separate affiliate safeguards and promoting competition in the market for in-region interLATA telecommunications ” *Audit Data Disclosure Order* ¶ 12.⁴ Even BOCs have recognized that the Act requires biennial audits that “fully test[]” BOC compliance with section 272. See Opp. of Bell Atlantic to AT&T’s Motion for Expedited Decision, at 7, CC Docket 98-121 (filed June 5, 2000)

Unfortunately, the audits at issue here were woefully inadequate, failing to conduct the proper inquiries and gather the evidence necessary to test fully Verizon’s compliance with the key Section 272 requirements. The audits were conducted pursuant to incomplete standards and procedures that were developed without the benefit of public comment and that have never even been publicly disclosed. A comparison of the audit reports with these “General Standard Procedures” (a copy of which AT&T requested and recently obtained from the Commission’s staff), reveals many instances in which the auditors did not comply with the General Standard Procedures. In many other respects, the audit reports fail even to disclose the scope of the audit inquiries. And many of the audit inquiries that are described rely upon patently inadequate measurements that are almost certain to miss or mask discrimination (because, for example, the selected measurements rely on overly aggregated data). Verizon frequently failed to provide the data requested by the auditors, and where data was made available, the auditors violated established sampling methodologies and failed to follow the requirement in the General Standard Procedures to examine all of the elements in some populations. In short, even if the auditors’ reports had given Verizon a clean bill of health, there would be no possible basis to conclude that Verizon complied with its Section 272 obligations during the audit period.

⁴ Order, *In the Matter of Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket 96-150, (Jan. 10, 2002) (“*Audit Data Disclosure Order*”).

The reality, however, is that although the auditors' inquiries were far too narrow to provide a complete picture of Verizon's post-entry behavior, they shed enough light on Verizon's practices to confirm pervasive discrimination and other anticompetitive conduct in violation of Section 272. In one month, for example, Verizon provisioned high speed special access services for its affiliate in less than 10 days; non-affiliates waited more than 25 days. That is no aberration – virtually *every* performance measurement disclosed in the audit reports shows that Verizon favored its affiliates over those affiliates' competitors. The auditors' reports likewise detail numerous violations by Verizon of its Section 272 obligations to, *inter alia*, operate independently from its affiliates, to keep separate books, records and accounts, to maintain separate employees, and to conduct affiliate transactions on an arms-length basis. Incredibly, the audits even revealed instances in which Verizon, in violation of Section 272(a), provided in-region interLATA services *directly*, rather than through a separate affiliate.

If the Section 272 requirements are to have any deterrent effect at all, the Commission must expressly recognize Verizon's pervasive violations and remedy them with substantial penalties. Verizon complains that the audit results are not statistically significant, but, as demonstrated in the attached declaration of statistician Dr. Robert Bell, the findings regarding many of the most egregious violations plainly are significant and representative of Verizon's standard operating practices. *See also* Opinion & Order Modifying Special Services Guidelines for Verizon New York, Case No. 00-C-0251, Opinion No. 01-1, at 19 & App. I, pp. 20-28 (N.Y.P.S.C. June 15, 2001) ("*NYPSC Special Access Order*") ("The November 24, 2000, Order required Verizon to substantiate nondiscriminatory treatment of its affiliates in comparison to other carriers. Verizon's compliance filings, however, did not refute the presumption of discrimination indicated by this difference in provisioning performance"). In any event, the

limited numbers of observations reported by the auditors are, in large part, a by-product of Verizon's failure to provide data requested by the auditors, and it would set the worst of precedents to allow Verizon to benefit from its own misconduct in failing to maintain or provide the data necessary to evaluate its compliance with its anti-discrimination and other Section 272 obligations

If nothing else, Verizon's attempt to use the superficiality of the auditors' inquiries to deflect attention from the Section 272 violations that those concededly inadequate audits were nonetheless able to uncover must be viewed as a concession by Verizon both that Verizon's own performance must be re-audited, and, more generally, that the Section 272 audit process must be radically reformed. With regard to the latter, the auditors' reports in this first biennial audit proceeding confirm that Section 272 audits cannot serve the vital detection and deterrence role that Congress intended absent immediate Commission action to implement standards and procedures that require specific, detailed inquiries that are consistent with sound auditing and statistical practices and sufficient to provide a complete and meaningful evaluation of a BOC's compliance with its Section 272 obligations. In particular, the Commission should complete the process it initiated in 1997, Public Notice, *Proposed Model For Preliminary Biennial Audit Requirements Under Section 272*, AAD No. 97-83, 12 FCC Rcd. 13132 (1997) ("*Proposed Biennial Audit Model*"), and establish auditing standards and procedures that require the auditors to evaluate a number of specific performance and other criteria (based, for example, on the New York PSC's groundbreaking efforts to detect discrimination), using specific sampling/auditing criteria, and to fully disclose the scope of their inquiries, their collection, sampling and analysis methodologies, and any failures by the BOC to maintain, collect and provide requested data

(which the Commission should penalize with a presumption of noncompliance for any affected measurements)

Verizon's foot-dragging has already delayed a Commission decision in this first biennial audit proceeding far too long, and the Commission should expeditiously issue its order recognizing and penalizing the Verizon misconduct uncovered by the audit and establishing and clarifying the standards and procedures for future audits. The Commission's order in this proceeding will undoubtedly be viewed by the BOCs as the benchmark against which their Section 272 conduct will be evaluated, and it is thus of paramount importance to consumers and competition that the Commission take a hard line here and confirm that it will not tolerate Section 272 violations and that future Section 272 audits must be much more rigorous, comprehensive and well-documented. *See, e.g.,* Remarks of Hon. Michael K. Powell, CompTel Annual Convention and Trade Exposition, at 2-3 (March 4, 2002).

II. BACKGROUND

A. Section 272 And The Commission's Implementing Rules.

To supply Bell Operating Companies ("BOCs") with incentives to comply with their market-opening obligations under the Telecommunications Act, Congress provided that, upon meeting all of the requirements of section 271, BOCs could offer the interLATA services that they have always been barred from providing by virtue of their bottleneck control over local facilities. 47 U.S.C. § 271. But Congress recognized that, even after full implementation of section 271's competitive checklist, local markets would not quickly become robustly competitive and that BOCs would still retain both the incentive and the ability to discriminate against competing providers of telecommunications services. *Non-Accounting Safeguards Order* ¶ 9. Section 272 reflects congressional recognition and concern over the abuse of bottleneck inputs that underlies all regulation of the BOCs' operations. *Id.* ¶ 9.

I. The BOCs' Anti-Discrimination Obligations

Section 272 includes a variety of nondiscrimination obligations, including a generalized and "flat prohibition against discrimination," *id.* ¶ 195 (*citing* 47 U.S.C. § 272(c)(1)), as well as more specific duties to ensure, for example, that competitors' "requests" for certain services, facilities, or information (among other things) are fulfilled as quickly and on the same terms as requests by the BOCs' 272 affiliates 47 U.S.C. § 272(e), *see Non-Accounting Safeguards Order* ¶¶ 237-71. With respect to the general duty, section 272(c)(1) provides that a BOC "may not discriminate" between its section 272 affiliate and "any other entity in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards." 47 U.S.C. § 272(c)(1). As the Commission has explained, section 272(c) establishes an "unqualified prohibition against discrimination by a BOC in its dealings with its section 272 affiliate and unaffiliated entities." *Non-Accounting Safeguards Order* ¶ 197. This antidiscrimination duty is to be applied using a "stringent standard." *Id.*

For the more specific nondiscrimination obligations, section 272 requires, *inter alia*, that BOCs may not discriminate with respect to i) the fulfillment of requests for telephone exchange and exchange access (§ 272(e)(1)), ii) the provision of facilities, services, or information concerning exchange access (§ 272(e)(2)), iii) the amount charged or imputed for access to telephone exchange and exchange access (§ 272(e)(3)), iv) the provision of interLATA or intraLATA facilities or services (§ 272(e)(4)).

All of these provisions were intended to prevent a BOC from using "its control of local exchange facilities to discriminate against its affiliate's rivals," and thereby, to ensure that "unaffiliated entities receive the same treatment as the BOC gives to its section 272 affiliate." *Non-Accounting Safeguards Order* ¶¶ 194, 204, *see id.* ¶ 206 (BOCs should "provide efficient service to rivals of its section 272 affiliate," and Commission's rules should therefore "require[]

that potential competitors do not receive less favorable prices or terms, or less advantageous services from the BOC than its separate affiliate”), *BA-NY Order* ¶ 402 (section 272 seeks to “ensure that BOCs compete on a level playing field”)⁵

2. Anti-Cross-Subsidization Provisions

As the Commission has stated, “if a BOC charges other firms prices for inputs that are higher than the prices charged, or effectively charged, to the BOC’s section 272 affiliate, then the BOC could create a ‘price squeeze,’” in which “the BOC affiliate could lower its retail prices to reflect its unfair price advantage.” *Non-Accounting Safeguards Order* ¶ 12; see *id.* ¶ 10. In recognition of the BOCs’ incentives to engage in price squeezes and other improper cost misallocation, section 272 also includes a variety of provisions that help “prohibit . . . cost-shifting” and aid in detection and prevention of improper cross-subsidization. *Id.* ¶ 9. Thus, the BOCs’ 272 affiliates must “operate independently” from the BOC, 47 U.S.C. § 272(b)(1), “maintain books, records, and accounts” that are “separate” from those of the BOC, *id.* § 272(b)(2), use “separate officers, directors, and employees” from the BOC, *id.* § 272(b)(3), may not obtain “credit under any arrangement” that provides a creditor with “recourse to the assets” of the BOC, *id.* § 272(b)(4), and must “conduct all transactions” with the BOC “on an arm’s length basis with any such transactions reduced to writing and available for public inspection.” *Id.* § 272(b)(5). Moreover, the BOC must “account for all transactions” with its section 272 affiliates in accordance with proper accounting principles. *Id.* § 272(c)(2). All of these provisions, and the Commission’s rules implementing them, help to create a “heightened transparency” between the BOC and its affiliates so that cross-subsidies can be deterred and

⁵ Memorandum Opinion and Order, *Application by Bell Atlantic-New York For Authorization Under Section 271 In The State Of New York*, 15 FCC Rcd 3953, ¶ 402 (1999) (“*BA-NY Order*”).

detected *E.g., Non-Accounting Safeguards Order* ¶¶ 158-59, 163, *Accounting Safeguards Order* ¶ 202

The Commission has adopted a host of rules to implement these provisions and to protect “ratepayers, consumers, and competitors against the effects of potential improper cost allocation” *Accounting Safeguards Order* ¶ 4. For example, the Commission prohibited the same personnel from performing “operations, installation, and maintenance [OI&M] services” on both the BOC’s facilities and those of the section 272 affiliate *Non-Accounting Safeguards Order* ¶ 163. That was because any such joint activity would “create *substantial* opportunities for improper cost allocation” *Id.* (emphasis added). Likewise, the Commission adopted strict rules governing the transfer of assets and facilities, and required BOCs to use particular methodologies for the “valuation of affiliate services” that were “more likely to ensure” compliance with section 272’s arm’s length transaction requirements and “guard against cross-subsidization of competitive services” *Accounting Safeguards Order* ¶ 147. As these and other Commission rules make clear, section 272 plays a role of “crucial importance”⁶

B. Role of the Section 272 Biennial Audit

Congress’s goal was to ensure that “durable competition in local markets” is maintained and that a BOC complies with the Act on an ongoing basis, and not merely at a “single moment in time” *Non-Accounting Safeguards Order* ¶ 333, *BA-NY Order* ¶ 453. Thus, section 271 contains enforcement provisions that can be used to remedy violations of section 272, 47 U.S.C. § 271(d)(6). More important for this proceeding, Congress expressly provided in section 272(d)

⁶ Indeed, section 272 is of such “crucial importance” (Memorandum Opinion And Order, *Application Of Ameritech Michigan Pursuant To Section 271*, 12 FCC Rcd 20543, ¶ 346 (1997) (“*Ameritech Michigan Order*”)) that the Commission has correctly held that its “findings regarding section 272 compliance constitute independent grounds for denying an application” pursuant to section 271 *BA-NY Order* ¶ 402.

that a BOC operating a section 272 affiliate “shall obtain and pay for a joint Federal/State audit every two years” to determine whether the BOC has complied with section 272 and the Commission’s rules, particularly with the “separate accounting requirements” in section 272(b)

This Congressionally-mandated audit requirement is a particularly vital tool to test compliance with section 272.⁷ In the Section 271 proceeding itself, the Commission is limited to making a predictive judgment about future compliance with section 272 based largely upon the BOC’s promises of future performance. See *Ameritech Michigan Order* ¶ 347. In reviewing Verizon’s section 271 application for New York, the Commission’s response to parties’ concerns that Verizon would not comply with section 272 was that the section 272 audit at issue here would provide a “*thorough and systematic* evaluation” of Verizon’s compliance with section 272. *BA-NY Order* ¶ 416 & n 1284 (emphasis added). The Commission’s approval of Verizon’s application was thus expressly based on its expectation that the biennial audits at issue here would result in “*stringent* post-entry oversight” of Verizon’s section 272 compliance. *Id.* (emphasis added). As these statements demonstrate, the Section 272 audit is a primary means by which the Commission can test compliance with the requirements of 272.⁸

⁷ See *Accounting Safeguards Order* ¶ 197 (“To obtain a fair assessment of BOC compliance [with section 272], we must ensure adequate oversight. Commission guidance of the audit process is crucial to assuring that the accounting and structural safeguards are in place and functioning properly. Because of the critical nature of accounting safeguards in promoting competition in the telecommunications market and the *critical role* the biennial audit will play in ensuring that the safeguards are working, it is essential that we establish effective biennial audit rules at the outset”) (emphases added).

⁸ Verizon’s predecessor, Bell Atlantic, has defended its allegedly improper conduct in a number of proceedings, including enforcement proceedings brought pursuant to section 271, by asserting that the biennial audit conducted pursuant to section 272(d) would “fully test[]” Bell Atlantic’s compliance with section 272, particularly the “current requirements on joint marketing.” See Opp. of Bell Atlantic to AT&T’s Motion for Expedited Decision, at 7, CC Docket 98-121 (filed June 5, 2000).

C. History of this Proceeding

1. Development of Audit Standards

In 1997, the Commission recognized the importance of developing detailed general audit standards and procedures, and “prescrib[ed] a specific report format” for the audit *Accounting Safeguards Order* ¶¶ 185, 200, *see also supra* note 7. That same year, the Commission issued a public notice calling for comment on a model for the audit requirements proposed by the BOCs, *Proposed Biennial Audit Model*, and AT&T and a number of other parties submitted comments and reply comments on the proposed model. By taking these steps, the Commission recognized that an audit is only as good as the procedures used to conduct it.

However, after delegating authority to a Federal/State joint audit team to review the conduct of the audit, *Accounting Safeguards Order* ¶ 198, the Commission never acted – at least in public – either with regard to the proposed model audit requirements or to the comments submitted on the model. Instead, applicable audit standards and procedures were apparently developed without any further public input. The audit report at issue repeatedly refers to a set of standards and procedures, *see General Standard Procedures for Biennial Audits Required Under Section 272 of the Communications Act of 1934, As Amended* (“*General Standard Procedures*”), but these standards and procedures were never released publicly, and the reasons supporting the adoption of these chosen standards were never explained.

2. Verizon’s Post-Approval Audit

The Commission approved Verizon’s section 271 application for New York in December 1999, triggering the audit process. The Commission re-affirmed that it would carefully monitor Bell Atlantic’s future performance and that it would not hesitate to use its “substantial powers” to ensure that Bell Atlantic continued to comply with its obligations under the Act, including its duties under section 272 not to unduly favor the long distance services of its affiliates. *BA-NY*

Order ¶¶ 16, 416, 446-53, see also Non-Accounting Safeguards Order ¶ 347, Accounting Safeguards Order ¶ 197

The audits were in fact conducted about two years ago, beginning in January 2000, only a few months after Verizon's affiliates were authorized to provide interLATA service in New York. By contrast, Verizon's application pursuant to section 271 was approved in less than three months, even though that proceeding raised a far broader number of substantial factual and legal issues. Because Verizon created a number of section 272 affiliates, audits of three affiliates were conducted: Bell Atlantic Business Services ("BABS"), which provides business long distance, Bell Atlantic Communications, Inc. ("BACI"), which provides consumer long distance, and Bell Atlantic Global Networks, Inc. ("BAGNI"), which builds telecommunications networks and serves BACI and BABS.⁹ However, no audit was ever performed for a fourth section 272 affiliate, Telecommunications Services Inc. ("TSI"), because Verizon did not disclose this affiliate's existence until June 14, 2001. See Auditor's Supplemental Biennial Report, Observation of the Federal/State Joint Audit Team for the Verizon Section 272 Biennial Audit.

Even though the Commission sought to adopt rules that "prescribed a number of deadlines to avoid prolonged delays in the audit's completion," *Non-Accounting Safeguards Order* ¶ 200, the audits were not publicly released until June, 2001 – six months after the audit period had concluded. Even then, significant amounts of audit information had been redacted, which made it impossible to fully evaluate or verify the auditor's findings, and AT&T and others requested that the redacted information be disclosed, either publicly or pursuant to a protective

⁹ An audit was also performed for the GTE Operating Companies' (GTOCs) and Verizon Select Services, Inc. ("VSSI"), see Auditor's Supplemental Biennial Report, Appendices C & F (the "GTOC/VSSI Audit"). In certain instances, these comments refer separately to the GTOC/VSSI Audit and the audits of the Bell Atlantic 272 affiliates listed above, ("the BA 272 Affiliate Audit"), but the principal critiques of the audits apply generally to the audit of each particular affiliate.

order *Audit Data Disclosure Order* ¶ 4 After numerous extensions to the date for filing public comments on the audits, the Commission released an order that rejected Verizon's request for confidential treatment for the redacted information, and concluded that "the public must have access to sufficient information to assess whether a BOC is adhering to the section 272 structural, transactional, and nondiscrimination safeguards." *Id.* ¶ 7

III. THE AUDITS WERE DEFICIENT IN VIRTUALLY ALL CRITICAL AVENUES OF INQUIRY, YET STILL INDICATE PERVASIVE VIOLATIONS OF SECTION 272.

On many key aspects of Verizon's post-approval compliance with the central provisions of 272, the audits failed to conduct the proper inquiries and gather the necessary evidence to shed light on the critical issues to be investigated in a section 272 biennial audit. (1) is the BOC discriminating against its affiliate's competitors? And (2) are the BOC and the affiliate engaging in improper cost allocation? Even though determining the answers to these questions is the central purpose of a section 272 audit, these audits could not possibly permit the Commission to conclude that Verizon is in fact complying with these critical obligations

Indeed, in many significant respects, the audit reports fail to disclose even the scope of the audit inquiries and thus do not provide the answer to a more basic question can the Commission, in fulfillment of its critical oversight role, *Accounting Safeguards Order* ¶ 197 ("Commission guidance of the audit process is crucial"), conclude that the audits were conducted in a manner so as to meaningfully assist the Commission in assessing Verizon's compliance with section 272? These audit reports are simply too sketchy to provide answers to that question as well Thus, even if the information that is disclosed in the audits revealed that Verizon and its affiliates had complied in every respect with section 272, the substantial gaps in information would nonetheless fall short of demonstrating that Verizon, in fact, complied with its section 272 obligations during the audit period However, despite gaps that would preclude a finding of